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Committee of the Whole for the Development Committee

Meeting 93/2

2:30 p.m., April 5, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	J. M. Abbott, Temporary
	V. Kural, Temporary
	A. M. Tetangco
	A. Törnqvist, Temporary
	T. Kanada, Temporary
	T. P. Thomas, Temporary
J. E. Ismael	K.-T. Hetrakul
D. Kaesar	
	M. C. B. Arreas, Temporary
	A. Mohzin
	G. Y. Glazkov, Temporary
	J. Papadakis
	P. Bonzom, Temporary
	A. Galicia, Temporary
	M. A. Hammoudi, Temporary
	B. Dlamini
	J. Dorrington
G. A. Posthumus	
	Y.-M. T. Koissy
	W. Laux, Temporary
A. S. Shaalan	Y. Y. Mohammed
	G. Lindsay-Nanton, Temporary
	Wei B.
	L. E. Breuer, Temporary

L. Van Houtven, Secretary and Counsellor
R. I. Vera-Bunge, Assistant

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<u>Also Present</u>
Development Committee: P. Mountfield, Executive Secretary; T. Kivanc. IBRD: K. W. Jun, International Economics Department. External Relations Department: M. R. Kelly, Deputy Director. Legal Department: R. H. Munzberg, Deputy General Counsel. Policy Development and Review Department: J. T. Boorman, Director; C. V. A. Collyns, M. E. Edo, S. C. Prowse, E. van der Mensbrugghe. Secretary's Department: J. W. Lang, Deputy Secretary; B. R. Hughes, A. Jbili. Treasurer's Department: S. M. Thakur. Advisors to Executive Directors: M. B. Chatah, J.-C. Obame, J. W. van der Kaaij. Assistants to Executive Directors: B. Abdullah, S. E. Al-Huseini, M. Dzervite, R. Kibria, S. Mills.

1. DRAFT PROVISIONAL AGENDA; AND JOINT ISSUES PAPER FOR SPRING 1993 MEETING

Executive Directors, meeting as the Committee of the Whole, considered the revised draft provisional agenda for the meeting of the Development Committee on May 1, 1993 (EB/CW/DC/93/1, Rev. 1, 3/19/93), together with a joint issues paper on developing country access to private capital flows (EB/CW/DC/93/2, 3/15/93).

The Executive Secretary of the Development Committee said that Directors had approved the draft agenda at the first Committee of the Whole meeting in January 1993. Since then, there had been one small addition to the agenda, namely, a separate list of the so-called supplementary papers. The Development Committee Chairman had considered such a list useful for the committee members. A separate, informal seminar-type meeting had been arranged to discuss the supplementary papers in the near future, primarily to give the opportunity to World Bank Executive Directors to review them. Fund Executive Directors were also welcome to attend.

The purpose of the present meeting was to approve the final version of the staff paper on developing country access to private capital flows, the Executive Secretary remarked. The Committee Chairman had had two meetings with the paper's authors and thought that, if it met with Directors' approval, it would be useful for the Committee's discussion.

The draft of the paper had been discussed the previous week at the World Bank's Executive Board, the Executive Secretary commented. The Bank's Directors had generally endorsed the paper but had made a number of detailed suggestions, which the staff was currently adding to the paper. However, none of those suggestions constituted fundamental changes.

As was routine, the Committee Chairman would circulate a paper of his own that would contain suggestions for the promotion of private sector flows, the Executive Secretary said. Furthermore, he would be contacting members of the Committee concerning practical arrangements for the meeting and he himself would be sending Directors copies of the documents.

The staff representative from the Policy Development and Review Department noted that the purpose of the meeting was to permit Directors to comment on the draft paper. Those comments would be incorporated in the paper to be issued to the Ministers for the spring Development Committee meeting.

Mr. Dorrington said that Mr. Peretz had recently circulated a memorandum on the issues under discussion to Executive Directors. That memorandum was wholly consistent with the one he had recently circulated to Directors in the World Bank.

Mr. Bonzom made the following statement:

I have just a few remarks to make on the paper entitled "Developing Country Access to Private Flows." First, I appreciate the focus that has been placed on the legal environment as a key factor for foreign direct investment. The need for an appropriate legal environment fully justifies the emphasis being given to technical assistance to countries with insufficient administrative capacities. It also justifies, in our view, Mr. Peretz's suggestion that more be written in the paper on bilateral or regional approaches by developing countries for attracting foreign direct investment.

Second, I agree that a sound and competitive banking sector is another basic prerequisite for the development of efficient capital markets and capital inflows. The paper correctly stresses, in this regard, the role of improved prudential regulations for all financial institutions in recipient countries. It also very rightly alludes to the need to persevere with financial reforms that are "consistent with the country's stage of economic development." As this is indeed a key issue, it warrants further elaboration. For example, the report might have been more explicit with respect to what is the most appropriate sequence of internal financial reforms in order to permit sustainable and stable capital inflows.

Turning now to the question of prudential regulations in industrial countries, the paper deals with the issue of modifying risk weighting in the Basle ratio. However, it would have been helpful if it had also mentioned, in greater detail, the arguments against reopening the Pandora's box of country classifications in relation to this ratio.

Third, the report analyzes well how policies can improve developing countries' access to private capital flows. However, it is equally important to analyze how those capital inflows affect developing countries' economic policies, and, more specifically, how those countries can manage macroeconomic policies in the framework of new and relatively volatile capital flows. This point could have been better emphasized and more thoroughly analyzed.

The first important policy issue that those countries have to face is the sort of dilemma that exists between monetary and exchange rate policies. When a country experiences strong and unexpected capital inflows, the resulting appreciation of the exchange rate might threaten its external competitiveness. In response, the country can relax its monetary policy, but there is a risk of fueling inflation. It is true, as suggested in the last paragraph of the paper, that, in those circumstances, a real appreciation of the exchange rate can be desirable and can simply result from a fundamental improvement in the efficiency of the traded goods sector. At the same time, many other factors can lead to such an appreciation, and there are certainly circumstances in which maintaining a stable nominal exchange rate is more appropriate.

More generally speaking, I think that the last paragraph of the document suffers from a certain ambiguity between short-term movements in the nominal exchange rates--whose economic benefits might be challengeable--and long-term adjustments in the real exchange rate--which are of course unavoidable. I would thus suggest deleting the last two sentences of this last paragraph or developing more fully the economic argumentation. I also think that more consideration could be given to the role that the exchange rate can play with regard to capital inflows. One key question is whether a stable exchange rate system is more or less conducive to capital inflows and, especially, to foreign direct investment, and this aspect could be introduced in the report.

I would suggest that the general issue of economic policy implications of private capital inflows deserves a full section of the report and not just a few paragraphs in the conclusion.

Lastly, I would like to say a word on the role of the international financial institutions. I agree with what is said in the report, and I especially agree that international financial institutions should continue encouraging investment flows to developing countries through the provision of policy advice and the financing of adjustment and reforms in host countries.

However, I can think of two other important roles that should be further emphasized in the report. The first role is providing financing (including concessional financing, for instance under an ESAF successor) when there is a satisfactory macroeconomic framework, but private financing remains insufficient. As stressed in the report, most inflows have been concentrated in a small group of countries, and, for many developing countries, the scope for private capital inflows is likely to remain tightly constrained. The second role is helping countries face the volatility or unsustainability of those capital inflows, that is, not only how to create conditions for appropriate and stable capital inflows, but also how to face unexpected situations of capital withdrawals--of capital outflows when those outflows are not caused by the macroeconomic situation, but by exogenous changes in the financial environment of the industrial countries themselves.

Mr. Al-Jasser made the following statement:

I broadly agree with the thrust of the staff paper on developing country access to private capital flows. Hence, I will restrict myself to a few comments. The paper offers useful background material for the forthcoming discussions on this subject. However, I feel that it is somewhat descriptive in nature and could have gone further in its recommendations. In particular, the section on the role of the international financial institutions is largely a description on their current activities in this area. It would have been more useful if the staff had presented some ideas on what additional actions could be taken by the international financial institutions to enhance capital flows to developing countries. Also, the section on prospects was largely a restatement of generalities. It would have been helpful if it had included some discussion of a few topical issues, such as the effects of exchange rate turbulence on the industrial countries, the impact of regional integration initiatives on the distribution of capital flows, and the implication of a recovery in the industrial countries for developing countries' capital inflows.

I have some concerns regarding the paper's treatment of questions related to the impact of, and the appropriate response to, large short-term capital flows. The matters raised in paragraph 6 of the issues for discussion section, and in the penultimate paragraph of the last section of the paper, have received considerable attention in several recent Board discussions. Following a brief review of this issue in the paper, some rather strong conclusions are drawn, most notably with regard to the unqualified efficacy of fiscal policy in such situations. The staff's exclusive emphasis on the need for fiscal adjustment in all cases of large-scale private inflows should have been qualified. In some cases, full sterilization of such inflows would not only increase the incentive for further inflows, but would also entail considerable fiscal costs. In some cases, these costs become the primary justification for further fiscal consolidation and could consequently set in motion a vicious cycle of sterilization, high fiscal deficits, and high interest rates. This issue should be addressed in the forthcoming Fund staff paper.

Mr. Abbott made the following statement:

Overall, the joint World Bank/Fund paper does an excellent job of discussing the subject of developing countries' access to private capital flows. That being said, we would like to reiterate two areas of concern. First, the paper places too much emphasis on source country regulation of banks and capital markets. Second, the paper's emphasis on encouraging bank lending through international financial institution cofinancing and relaxation of Basle capital adequacy requirements is misplaced, particularly given the secondary role now played by commercial banks in development financing.

With respect to the first concern, we would emphasize that the flow of private capital to developing countries, as well as the level of domestic savings, is driven primarily by the macroeconomic and investment environment of the host country, not the regulatory regimes of the source countries. The primary role of international financial institutions in this regard should be to promote macroeconomic and structural reforms in order to broaden the number of countries benefiting from private capital flows.

We believe that it is not realistic to expect that there will be any significant increase in commercial bank lending to developing countries any time soon. As such, it would make more sense for the Development Committee to focus on other types of private capital flows. For example, changing the Basle Accord to provide for a more graduated risk-weighting system would not be productive. While there is an argument for graduated risk weighting for developing country credits according to the creditworthiness of the borrower, as a practical matter, changing the Basle Accord would have little or no effect on the lending patterns of commercial banks and would prove to be a complex exercise, creating more problems than it would solve. In this, we agree with Mr. Bonzom that this is something of a Pandora's box that should well be left closed.

We would also strongly question the assumption that commercial banks should be encouraged, through cofinancing with international financial institutions, to increase lending to developing countries. Moreover, concerns about the potential volatility of private capital should not be used as a rationale for clamping restrictions on capital flows. In fact, capital restrictions, or the threat of capital restrictions, are likely to increase the volatility of capital flows. I would like to say that I fully agree with Mr. Al-Jasser's comments on the treatment of this issue of capital flows and the role of fiscal policy in sterilizing, or not sterilizing, the inflows, and I would like to see that issue clarified a bit.

Regarding the question of the ambiguity of the relationship of the exchange rate in the adjustment process to capital inflows--an ambiguity that Mr. Bonzom called attention to--I think our view is that the issue is sufficiently complex that maybe we should just settle for ambiguities at this stage. Finally, we share the view that the paucity of data on private capital flows, in particular portfolio investments in emerging markets, must be corrected if host countries and the international community are to monitor developments and be in a position to deal effectively with any future financial problems.

Mr. Hammoudi made the following statement:

We welcome this opportunity to discuss the Development Committee agenda and the focus put on private sector development and capital flows for developing countries in the papers for discussion before us.

Generally speaking, although the papers show that, globally, aggregate GDP growth seems encouraging for developing countries, many of those countries continue to face serious economic problems, despite the structural reforms that have been implemented. The low-income and lower middle-income countries, especially in Africa, are plagued with debt burdens, stalled economic growth, and low standards of living. Therefore, we should insist that capital flows and open access to industrial countries' markets would help developing countries to overcome their economic and financial difficulties.

On the issue of technical assistance, although we are pleased by what is provided by the World Bank and the Fund, we should look at studies that suggest that strengthening public sector management capacity and promoting human capital development are essential for building sound and sustainable economic growth, as is well proven by the East Asian experience.

The debt problem continues to hamper adjustment efforts of low-income as well as low middle-income, and middle-income countries. There should be ways and means to reduce the debt burden that blocks economic recovery and development of those countries. Indeed, solutions already envisaged should be implemented in a timely manner for all these countries.

Trade is another domain in which we should point out the concern of the international community, especially with respect to developing countries that are experiencing barriers and restrictions while they are opening their markets through comprehensive economic reforms. We are convinced that world open markets would solve much of their financial difficulties. In this regard, it is vital for the world economy to see the Uruguay Round of negotiations completed.

On developing country access to private capital flows, we recognize that some progress has been made; nevertheless, much remains to be done. Indeed, a number of developing countries have been emerging from the debt crisis and are regaining some access to capital markets, while many countries are still striving to cope with their high debt burden as stated above.

Concerning regulations governing capital flows, we are pleased with the comments on source country relaxation of Basle capital-adequacy requirements, and we welcome the suggestions on international financial institutions' cofinancing. We believe that easing the current rules as suggested, as well as strengthening the cofinancing strategy, could lead to more capital flows to developing countries, especially those that are implementing economic reforms in cooperation with the Fund and World Bank.

To promote capital, monetary, and foreign exchange markets, technical assistance to developing countries is needed to enable them to host foreign capital flows adequately and stimulate and manage domestic capital flows. The international financial institutions, especially the Fund and World Bank, could play a central role in those domains.

On the progress report on private sector development, we are encouraged by the actions taken by the World Bank, especially in the technical assistance field, to assist developing countries in promoting an adequate legal framework, as well as stimulating foreign direct investment. We have noted that problems and complexities remain in this sector and need to be addressed when taking into account the culture, nature of the social institutions, and the administrative capacity of the host country.

In our view, modernizing financial institutions and promoting capital markets, as well as initiating decentralization, are essential to the success of the private sector in developing countries. In this respect, the role of international financial institutions, the World Bank and Fund in particular, is more than important.

The IFC-MIGA strategy has to be strengthened with the objective of promoting and substantially stimulating foreign direct investment and joint ventures in developing countries, especially in sub-Saharan Africa.

In this regard, special attention should be given to small and medium enterprises, which are so efficient in creating job opportunities that are much needed for social stability in developing countries.

Concerning the IDA negotiations, it is urgent to conclude those negotiations, and we call upon all member countries to speed up the process in order to complete the tenth replenishment and improve the World Bank's financial resources, which are so needed to assist low-income countries. This could help the World Bank to enhance its strategy in addressing poverty problems and alleviating debt burdens, as well as reviving the low-income economies in the framework of structural reforms.

Finally, it is crucial that actions follow recommendations in order to encourage capital flows to developing countries, which, in turn, have to pursue their adjustment efforts. At the same time, it would be a wise step if industrial countries would open their markets to those countries so as to encourage economic reforms and to pave the way for more liberal world financial and trade markets. This could allow developing countries to count primarily on their own revenues from exports rather than on the external financial assistance. In this respect, quick conclusion of the Uruguay Round negotiations would be helpful. Moreover, encouraging private sector development and promoting foreign direct investment are the fundamentals for an economic recovery and sustainable growth in the developing countries that could also benefit the world economy if the 1990s is not to be another lost decade for these countries.

Mr. Koissy said that the staff paper prepared in connection with the forthcoming meetings of the Development Committee was a good basis for ministerial discussion. Of course, many questions not fully covered in the paper would have merited some thought; for instance, the question of the legal treatment of foreign direct investment. Moreover, he regretted somewhat that the paper did not cover one of the aspects that his chair had suggested during the previous meeting on the steps that international financial institutions should take to enhance regional cooperation, in particular in sub-Saharan Africa, so as to create broader and economically sound entities that could better attract, in terms of profits, foreign investors.

Mr. Dlamini made the following statement:

This chair attaches great importance to the work of the Development Committee, and the agenda should provide ministers with the opportunity to deliberate on issues relevant to the development agenda. In order to enhance the effectiveness of the Committee's work, the discussion should lead ministers to come up with concrete decisions and recommendations. In general, the on-going efforts to improve the effectiveness of the Development Committee should continue to be strengthened.

The paper entitled "Developing Country Access to Private Capital Flows" reveals that the situation in low-income countries continues to raise some fundamental questions of concern. Even though the staff has acknowledged that prospects for private capital inflows to some of these countries, especially those in sub-Saharan Africa, would remain poor, it has not come up with any practical solutions to be recommended for consideration by the ministers. Given the limited savings potential in these countries, it is obvious that this group of countries will continue to rely on concessional external finance in order to build their physical, economic, and social infrastructure, which is necessary for the promotion of private sector activity. Specifically, two needs can be identified from this exercise: the adequacy and timeliness of external financial assistance; and the possibility of improved access to private capital markets to support ongoing efforts in these countries to restructure their economies, including the privatization of state enterprises.

With regard to external financing, I believe that the ministers will consider the matter in the context of the progress report "Private Sector Development: A Progress Report." Apart from taking note of the report, my authorities expect a more focused debate on prospects for substantially increasing official development assistance, on a further and more serious consideration of the enhanced Toronto terms, and on the role and effectiveness of development assistance by international financial institutions, including the Fund and the World Bank. In the case of the Bretton Woods institutions, the ongoing efforts on IDA-10 and the possible successor to the ESAF are encouraging steps in the right direction.

On the issue of access to private capital markets by developing countries, the staff paper fails to discuss specific proposals for how low-income countries can gain access to such markets. As already intimated, ministers would have been greatly assisted if some practical solutions had been incorporated into the paper. Such proposals could be linked to the ongoing privatization programs being implemented under the Fund and Bank-supported adjustment programs.

Despite the reforms already undertaken in many low-income developing countries, the continued foreign investor reluctance to invest in these countries should be studied more closely. There may be some useful lessons to be learned from the experience of the recently industrialized countries of East Asia. We, therefore, propose that such an in-depth study be undertaken by the staffs of the two institutions, especially the Bank, which the Committee could consider at a later date.

Mr. Shaalan said that he endorsed the draft provisional agenda. With regard to the paper on capital flows, he shared Mr. Al-Jasser's and Mr. Abbott's views and had serious misgivings about the analysis and recommendations concerning the complications to economic management caused by short-term capital inflows. The paper heavily favored the use of fiscal adjustment to address that problem. That was a serious issue confronting a number of countries, and more analysis, including a thorough study of other possible options, was called for.

Mr. Tetangco made the following statement:

> I have two brief comments on the issues paper. The first relates to the Uruguay Round. We strongly support the call for its successful conclusion. We agree that this will improve the profitability of investments in developing countries by enhancing their access to industrial country markets. Considering its importance, it may be helpful to strengthen the section on this issue in the paper by, for instance, pointing out what the consequences would be of a failure to conclude the Round.
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> My second comment is related to the suggestion made earlier by Mr. Al-Jasser and other Directors. It would indeed be useful to clarify the possible policy responses to substantial capital inflows. While fiscal adjustment is obviously important, there should be further analysis of other possible ways of dealing with such a phenomenon. This is particularly important in cases in which either the fiscal adjustment has already been significant by itself, and further adjustment becomes difficult without producing negative effects in other areas, or the room for adjustment is limited to begin with. The latter case is the situation in which a large part of the budget goes to debt service. It is clear in this case that there is little room for a country to maneuver without harming its relations with its creditors. The paper recognizes these constraints, but further elaboration of such problems can perhaps be made in the paper currently being prepared by the staff on experience with surges of capital inflows.

Mr. Glazkov made the following statement:

> I would like to endorse the draft provisional agenda.
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> As for the staff paper, it is a very good one. I would like just to comment on two issues. There are two main groups of factors influencing access to private capital flows, that is, the internal ones, such as the legal environment and macroeconomic stability, and the external ones. I think that everything that was said in the paper on the internal factors is correct. As for the external factors, I would make a few remarks. For example, the paper indicates--quite correctly--that developing countries'

investment profitability is influenced by these countries' access to industrial country markets. Furthermore, mention is made of the necessity to promote an open international trading system. However, I think that more attention should be paid to this need, because this is one of the main obstacles to development, especially if the new group of developing countries, the former centrally planned economies, is taken into account. These countries have a dual status of being developing countries and, in a way, industrial countries at the same time. The question of access to industrial country markets is a most important issue for them. Thus, I think that more attention should be paid to this issue and more analysis provided in the paper.

As for the inflows from international financial institutions, I think that some notes should be prepared on the policy options of these institutions and on the need to provide a consistent but flexible policy. The World Bank's recent decision with respect to the negative pledge provides a good example of this.

Mr. Kaeser noted that several speakers had referred to the ESAF in their comments on the paper on developing country access to private capital flows. The Managing Director's comments on ESAF to the Interim Committee could be transmitted to the Development Committee.

The Executive Secretary of the Development Committee said that the Managing Director would probably include his remarks to the Interim Committee on the ESAF successor in his statement to the Development Committee. One of the supplementary papers for the Development Committee would address the experience of the East Asian countries as a group.

The staff representative from the Policy Development and Review Department noted that several speakers had expressed concern about the treatment of low-income countries in the paper. The Executive Secretary had circulated a work program to the Bank and Fund Directors proposing possible topics for discussion at future meetings of the Development Committee. The program included the adjustment experience of, and external financing for, low-income countries. If a paper were prepared on the issues of low-income countries for the 1993 Annual Meetings, those issues could be addressed in that forum. There had been a discussion in the Fund Board on the adjustment experience of countries with ESAF arrangements. The World Bank was conducting research on many of those countries with respect to stand-by arrangements, which could possibly be discussed in the near future by the Development Committee.

Several speakers had commented on the importance of the completion of the Uruguay Round and of access to export markets for developing countries, the staff representative noted. References to those issues had already been made in the paper, but the staff would examine them again to see if further work was needed.

the staff representative said. Nevertheless, the staff did not underestimate the difficulties of reopening that issue and reaching a new agreement.

A paper on developing countries' recent experience with surges in capital flows was being prepared for discussion in the Board in the near future, the staff representative remarked. A few of the factors highlighted in that paper were relevant to the current discussion. Among the different underlying factors that caused surges in capital inflows that were mentioned in the paper were stricter domestic economic policies, fundamental real changes, such as declines in the fiscal deficit or changes in external competitiveness, and external factors, such as changes in international interest rates. Surges in capital inflows in developing countries could cause difficulties with monetary policy control, exacerbate inflation, leave countries vulnerable should outflows occur, or precipitate deterioration in the external current account.

In many cases involving heavy capital inflows, attempts to restrict those inflows had not been successful, the staff representative from the Policy Development and Review Department observed. In one case, there had been an improvement in external competitiveness and the inflows had been sustainable over time. However, in other cases, it was not clear whether the inflows were permanent or reversible, and what the balance should be between fiscal, exchange rate, and monetary policies. The paper would examine the underlying responses to the inflows that would generate changes in the real economy.

APPROVED: December 15, 1993